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Bankruptcy and Receiverships

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BANKRUPTCY AND RECEIVERSHIPS

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Professional people are called upon to serve business, particularly small business, in many ways in our present complex economy. When credit problems are involved, the credit grantors rely heavily upon the accountant. The client relies upon him for wise counsel, particularly when he meets financial reverses.

What is the role of the accountant in respect of the financially embarrassed client? What is his position? What are his duties and responsibilities? The accountant usually senses the bad condition before the client is fully aware of his problem. Those who have had experience in bankruptcy and insolvency matters know the importance of full disclosure of the true financial condition to the troubled debtor. The client must not deceive either himself or his creditors.

When an accountant appears before a creditors meeting, he must be fully conversant with the operations of his client's affairs. The following is a check-list of items needed at such a meeting:

1. Fully verified balance sheet and operating statement, properly prepared.
2. Complete schedules of accounts receivable and accounts payable, properly aged.
3. Complete physical inventory, listing merchandise on hand by general classification, age, cost, and sound value.
4. Forecast of operations, and, a suggested schedule of changes to remedy the conditions that led to unprofitable operations. (This is especially desirable if the debtor desires to continue the business.)
5. Statement of affairs, so that the creditors may evaluate the results of forced liquidation.
6. Schedule of insurance coverage.
7. Report on corporate records disclosing the names of officers, directors, and stockholders.
8. List of all unfilled sales orders, showing quantity, prices, customer, amount, and delivery date, in respect of each.
9. Schedule of purchase commitments, showing names, items, prices, amounts, delivery dates, and present market value of the items included.
10. Statement of cash receipts and disbursements for a period of four months prior to the meeting, to assure the creditors that no preferences have been made in payment of obligations.
11. Statement of contingencies, if any, status of tax audits, and other information that would assist creditors in deciding whether the debtor should be permitted to continue in business or be required to liquidate.
12. Covering letter giving a brief history of the company and a full analysis of operations that led to the financial difficulties.

It is always to the benefit of the creditors and client to invite an attorney, experienced in bankruptcy matters, to represent the client in presenting any proposals that may be contemplated. The attorney will be helped by the advice and recommendations of the accountant. The accountant should be well informed as to the possibility of continuing the business and the methods of operating under a creditors committee, or the desirability of liquidation and the various methods of accomplishing liquidation. He must be prepared not only to present the facts of the case in an orderly manner but to make recommendations upon which both the client's attorney and the creditors' committee may act.

It may seem of little consequence to the debtor what form of liquidation takes place if that is the disposition decided upon. This is not so. The debtor may have a substantial stake in the results of the liquidation even though the proceeds do not flow to his pocket. The greater the yield to creditors, the greater the chance that the debtor may obtain future credit in a new venture.

Wherever possible, liquidation should be avoided. A business, the failure of which can be traced to remediable causes, may well have the rudiments of a successful enterprise once its shortcomings are corrected. In such situations, alternatives to liquidation are available.

Once common practice in continuing a sick business that is usually beneficial to the debtor and preferable to creditors is to invite one or more of the larger creditors to an informal meeting with the debtor's attorney and his accountant. Frequently, when a small corporation is involved, the stockholders are personally liable, under guarantees, for corporate debts. If the debtor liquidated the business under a plan acceptable to creditors, he would have a better opportunity of relieving himself of financial responsibility under these guarantees either fully or partially.

Proper relationship with creditors should be maintained. When an accountant is questioned regarding the affairs of a debtor client, he should divulge financial facts regarding the client's business only after having obtained the consent of the client. These facts should be complete. Contrary to the impression held by many, it will not hurt the client to reveal losses that have taken place. Withholding such information would only mislead creditors and do more damage than a forthright statement of the facts. If the creditor feels that he has received complete information, even though it is bad, he at least knows that he has the worst picture. On the other hand, if he feels that the information given is incomplete, he will assume that the condition is worse than it actually is. Undoubtedly such a strained relationship between debtor and creditor is more detrimental to the debtor than one in which the creditor is fully informed. The creditor who is fully apprised of the debtor's position and asked to come to his assistance will be more amenable to suggestions leading to an orderly solution to the problem.

Insolvency investigations frequently present to the practitioner many involved problems of a legal, as well as an accounting nature. These were augmented by the enactment of Chapter XI of the National Bankruptcy Act. Close cooperation with the attorneys concerned is a prerequisite for a successful engagement.

It has been well stated that a Chapter XI proceeding is one initiated by an embarrassed debtor for the purpose of effecting an arrangement with his (or its) creditors. Where the debtor is permitted to continue the business, as is often the case, he is referred to as the "Debtor-in-Possession". The accountant for such Debtor-in-Possession plays an entirely different role than the accountant for the financially embarrassed client.

In these matters the accountant is often retained either with the consent of or at the request of the Creditors' Committee, pursuant to a formal petition of the debtor which has been granted by the Court. The work of the accountant in a Chapter XI proceeding will, of necessity, vary greatly with each case because his services are restricted to those that were set forth in the original retention order, supplemented by the additional orders, if any. In implementing these Court directives, some of the factors which will affect the scope of the accountant's engagement are as follows:

1. The nature of the business, the length of time the debtor was in business, his reputation.
2. The amount and nature of his assets and liabilities, not only as set forth in the schedules accompanying the petition for arrangement, but also as gleaned from the preliminary survey of the books and records.
3. The extent of the operations of the business.
4. The duration of the period of the proceedings. (Sometimes they are quite lengthy.)

The accountant must exercise considerable judgment and ingenuity in formulating an audit program that will meet the requirements of all concerned. At the inception, the major responsibility of the accountant revolves around his investigation of the affairs of the debtor and the submission, at an early date, of copies of his formal report to the debtor, Creditors' Committee, and their respective attorneys. The contents of such report may include:

1. History of the business, its capitalization and management, and analysis of the reasons for its financial distress.
2. Balance Sheet, supported by detailed schedules as of the date of the proceedings. In this statement, the assets should be grouped on the basis of whether they are pledged or free, and secured obligations should be deducted from the assets to which they relate. Further, accounts receivable credit balances as well as accounts payable debit balances should be shown separately on the statement. Liabilities should be shown in three groupings, namely, priority, secured, and unsecured. It is also desirable to present pertinent comments regarding the more important items on the financial statement.
3. Comparative Balance Sheets in condensed form, for past years.
4. Comparative profits and loss statements, by years, together with an analysis of the operations on a percentage and unit basis. This is frequently helpful in uncovering some of the weaknesses of the business.
5. Summary of discrepancies, if any, be-

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IDEA EXCHANGE

By **THEIA CASCIO, Beverly Hills, California**

For Legible Hand-written Copies

From Nellie Joling of Grand Rapids Chapter comes the suggestion to use indelible pencils in preparing manual records where several copies are required — such as payroll records. Use of the ball point pen often results in slurred carbon copies. A sharp indelible pencil will give clean, legible copies for permanent records.

Payroll Savings Bond Accounts

Here is a method that has proved highly satisfactory in keeping employees Payroll Savings Bond accounts posted up-to-date, so that one can readily determine the status of each individual account:

Give each employee under the Savings Bond plan a code number to be used by the Payroll Department for the deduction record. Use a ledger card for each employee, showing his Code Number, Name or Names and Addresses of the person or persons in whose name the Bonds are to be registered. Also, show the denomination of the Bonds preferred. Post the credit to each employees account for each payroll period, accumulating the totals.

Whether bonds are bought monthly or semi-monthly, it can be determined readily the number and denomination of Bonds to be purchased and his account can be charged accordingly. This procedure has been effective for Minnie Haan of Holland Chapter.

Reconciling Vouchers Payable

Elizabeth S. Rodkey, Baltimore Chapter, suggests time can be saved in tape running when reconciling Vouchers Payable by the following method:

Determine the Vouchers Payable current balance by deducting the total of checks paid as obtained from the Check Register from the Vouchers Payable account, taking into consideration any open Journal entries affecting these accounts. This is the net total of Open Vouchers, and should agree with the total of a list of open items from the actual vouchers.

If the two figures do not agree, review the checks to be mailed to payees to determine if check or voucher is incorrect. Only after exhausting this possibility, take on the laborious task of verifying each amount in the Voucher Register against the distribution ledger postings and the Check Register.

Helpful Pamphlets

Paula Reinisch of Grand Rapids Chapter suggests the following booklets to help with accounting department problems:

"Index to Modern Figuring", furnished by Marchant Calculators, Inc.

"Selective Control of Business Information", a 28-page booklet showing the application of Addressograph-Multigraph Corporation's methods in accounting and statistical functions.

"Welfare Fund Accounting for Building Trades", put out by International Business Machines Corp. This describes procedures used for welfare fund accounting in two cases — a statewide plan operating on a weekly basis, and a local plan for trade functioning on a monthly basis.

"Accounting May be the Right Field for You", a 24-page career booklet providing a comprehensive explanation of the nature of the certified public accountant's work, educational and experience qualifications for becoming a C.P.A., and opportunities in accounting. Single copies free on request to American Institute of Accountants, 270 Madison Ave., New York 16, N.Y.

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tween the books and records and the financial statements that were issued to credit agencies and others.

6. Schedule of irregular transactions, if any, during the period prior to the date of the proceedings. This may include withdrawal of capital, transfer of assets without proper consideration, etc.
7. Schedule of possible preferential payments, by case or otherwise, made to affiliated companies, principals, creditors, etc., during the preceding four month period or longer.
8. Comments regarding the schedules and plan of arrangement that was filed by the debtor. Generally the initial proposal submitted by the debtor is merely a stopgap plan, because of the requirement of the Bankruptcy Act, and is quite dif-

ferent from the one that is finally approved. The accountants may make constructive suggestions which will be helpful in the formulation of a fair, equitable and feasible plan. Of course, such suggestions must be based upon the facts revealed by his examination coupled with his specialized accounting and business background. His comments should be rendered in a tactful manner in order to invite cosideration from all parties to the problem.

It is well to reiterate that the scope of the audit report will depend upon the circumstances of each individual case.

After the accountant has submitted his report, he should be prepared to confer with the debtor and creditors' committee, or their attorneys, either separately or jointly.

Inasmuch as the transactions subsequent to the date of Chapter XI petition must be kept separate because of legal requirements, the accountant should, after consultation with the attorney for the debtor, prescribe the revisions that are needed in the accounting system.

The courts require a Debtor-in-Possession to file statements, usually monthly, of cash receipts and disbursements.

Until such time as the Chapter XI proceedings are terminated, either by formal confirmation of the debtor's plan or by subsequent bankruptcy proceedings, the accountant occupies a very delicate position because of his dual relationship with the debtor and creditors, in addition to the Court. It is therefore most important that he perform his duties with the highest degree of efficiency and independence.

The exercise of sound judgment and extreme discretion was never more important than in engagements of this character, because the manner in which inherent weaknesses or irregularities in the business are reported by the accountant may vitally affect the entire course of the proceedings. The debtor should, therefore, be afforded every opportunity to supply complete explanations, wherever required, in order to prevent unwarranted criticism, from any source, being injected into the proceedings.

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Organizational expenditures—Paid or incurred on or after August 16, 1954 may be treated as deferred expenses at the election of the corporation. If the election is made, the expense may be deducted ratably over a period of not less than 60 months, starting with the month in which the corporation begins business. This election must also be made not later than the filing date for the first corporation return for any taxable year beginning after December 31, 1953 and applies to all subsequent taxable years. (Code Sec. 248)

Liquidation of a corporation—Sales during 1954—the 1954 Revenue Code provides for non-recognition of gain or loss on a sale of assets accompanied by the distribution of all assets in complete liquidation in a 12-month period beginning with the adoption of a plan of complete liquidation adopted after December 31, 1953 and before June 22, 1954. (Code Sec. 392 (3))

Liquidation in one month—Recognition of gain—The law requires that written elections must be made according to regulations relating to Sec. 333 within 30 days after the adoption.

Under the 1939 Code the furthest extension of the election made it apply to liquidations occurring within one month during the calendar year 1953. As made permanent by the 1954 Code, the election applies only in the case of liquidation plans adopted on or after June 22, 1954. It is not necessary that the month of completion must fall within the taxable or calendar year in which the plan is adopted according to the report of the Senate Finance Committee. (Code Sec. 333)

Partnerships and Proprietorships—Election to be taxed as a corporation—For taxable years beginning after December 31, 1953 and ending after August 16, 1954, a partnership or proprietorship which meets certain requirements may be taxed as a corporation if the election is made not later than 60 days after the close of any taxable year to which the election is first applicable, by the proprietor or, in the case of a partnership, by all the partners having an interest in the enterprise at any time on or after the first day of the taxable year. A new election must be made if, because of a change in ownership, the capital and profits interest of the electing proprietor or partners decreases to 80% or less.

In order to qualify for this election the enterprise must be one in which capital is a material income—producing factor or in which 50% or more of the gross income consists of profits derived from buying and selling real property, stocks, securities or commodities for the account of others. The enterprises must also be owned by less than fifty persons, none of whom may be a nonresident alien. No proprietor or partner having more than a 10% interest in an electing enterprise may be an owner of